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THE DIRECTOR OF
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NOTE FOR: Hal Ford
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FROM: [redacted]
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SUBJECT: Attached for the World-Wide Briefing

This is intended to replace David Low's earlier contribution on economics for the World-Wide Briefing.

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8 February 1985

Economic Challenges for 1985

Third World Debt

Members of the financial community are generally pleased with the progress made on the international debt problem last year.

-- The crisis atmosphere has largely subsided as trade balances improved and the largest debtors began to reach agreement with their creditors.

-- Mexico, Venezuela and Ecuador obtained multiyear restructuring agreements last year.

-- Brazil is heading toward an agreement, and Argentina and the Philippines have come to terms with the IMF.

During the past three years we have seen a dramatic turnaround in the trade performance of these countries, as the non-OPEC LDCs trimmed some $70 billion from their trade deficits.

-- While the majority of this turnaround in the early stages came from reductions in imports, more recently we have seen a more positive type of adjustment as export growth, spurred by demand from the United States, has resumed.

While the trade adjustment and massive currency devaluations that helped bring it about were forced by lack of financing, these governments now must adjust their domestic economies to improve economic conditions absent the $20-30 billion in annual commercial bank and that helped fuel prosperity in the 1970s.

-- Living standards are still depressed, in part due to the forced import reductions; in Latin America, per capita output has fallen 12 percent in three years.

-- Savings rates are below those that existed in the 1970s and domestic investment is down sharply in many countries.

-- Price increases have accelerated with several countries experiencing triple digit inflation.

The outlook on these fronts is not good, even for countries with established adjustment programs. Despite efforts to trim domestic spending, public sector deficits in many countries remain large, in some instances well above guidelines negotiated with the IMF.

-- Brazil, for example, saw inflation rise to 200 percent in 1983/84 and its public sector borrowing level of 18 percent is double the IMF target.

-- [redacted] the Mexican government believes that its public 25X1
deficit may approach 9 percent this year--nearly triple the IMF target--and inflation could level off near 60 percent--double the planned rate for 1985.

-- For some countries, notably Mexico and Venezuela, the threat of further oil price declines also looms as a serious concern.

In some instances, such as Brazil and Argentina, this difficult line between politically practical economic actions and necessary measures to prevent an erosion of trade gains will fall on relatively new and untested leaders. In any case, the political cost of making domestic economic

adjustments seems to be rising, to judge by the apparent unwillingness of Brazil, Mexico, Argentina, and others to be more forceful in their efforts to constrain wages, money supplies, and inflation.

Other Issues

Two other economic issues will also take much of our time this year--China's momentous decision to reverse economic direction and the impact of a possible major decline in world oil prices.

Bejing's decision to move beyond agricultural reforms and allow greater freedom for small-scale industry has major implications for other countries.

-- China's moves promise to isolate even further the Soviet Union and its rigid model of industrial development.

-- The countries in Eastern Europe are watching with a large measure of envy as China strikes out on its new course.

-- In the free world, firms are scrambling to set up joint enterprises with the Chinese or to increase exports to them.

We also see the Chinese experiment in the broader context of a healthy reform movement taking place in the less developed countries. Under the financial pressures of the twin oil crises and global financial crunch, some countries are moving away from the socialist model and are allowing free enterprise to have a larger share of economic activity.

-- Several countries, for example, are taking a more positive approach to agriculture, dropping consumer subsidies and allowing farmers to receive more realistic prices.

This year may also prove to be a watershed for the OPEC cartel. OPEC is having increasing difficulty marketing its oil at current prices and many analysts believe that a decline in oil prices anywhere from $5 to $10 per barrel is possible.

There would certainly be much benefit in a major decline in oil prices; much of the world's $1 trillion plus annual energy bill is tied to oil. A decline in the import portion of this bill would give a boost to the Western economies and allow them to broaden their gains in the current recovery.

There is also a downside to an oil price decline, however.

-- In the United Kingdom, the weakness of the pound related at least in part to oil prices has already caused the government to adopt some restrictive economic measures.

-- Elsewhere in Europe, decisions to develop expensive North Sea gas as the major alternative to increased Soviet supplies in the 1990s would likely be sidetracked.

-- In the Middle East, the financial blows would fall most heavily on Arab states and, from there, trickle down in the form of reduced worker's remittances and aid to several African and Asian countries which rely on them for support.